Oil Price and Interest Rate Hikes: A Lethal Combination

by Richard Freeman

The escalating price of crude petroleum, the leading edge of a worldwide Weimar-style hyperinflationary process, is in the initial phase of wrecking economies from Japan and the United States, to the developing world. On May 20, Bank of Japan Governor Toshihiko Fukui stated that "oil prices and their impact are areas that we will be watching extremely carefully." Fukui added that Japan is heavily dependent on imported oil, especially from the Middle East, and very vulnerable to a large rise in oil prices. The May 13 *Yomiuri Shimbun,* in an article entitled, "Oil Price Rise Prompts Crisis Fears," reported that some analysts are predicting "an oil crisis reminiscent of those that stalled industrial economies during the 1970s."

However, the most extensive damage of an oil price increase is inflicted on the United States. On May 19, the price of U.S. light crude futures contracts for June delivery closed at $41.70 per barrel on the New York Mercantile Exchange (NYMEX) in after-hours trading, the highest such futures contracts closing since the NYMEX started trading them in 1983. The heavily indebted airline industry is in or near bankruptcy, and cannot sustain much greater price increases. On May 20, United and American Airlines announced a $10 surcharge per passenger ticket to offset the hemorrhaging they are suffering from rising jet fuel costs. American truckers, whose diesel fuel price has risen by 40%, have staged shutdowns which have closed sections of America's highways. Industry and the citizenry are being hit in multiple ways from the price increase, in ways that are causing extreme hardship.

Conceptualizing the already shaky condition of the American economy, Presidential candidate and economist Lyndon LaRouche had issued a prescient warning May 12 at a Fayetteville, Arkansas televised candidates' forum. He declared, "The extension of this war into the so-called Middle East means a threat—with oil now going at $40 a barrel, any new crisis in the Middle East could send the price of oil up to $50 or $60 a barrel. . . . When you're talking about petroleum, . . . $20 is about [the] level for stable effects on the U.S. economy. When oil goes up to $40 a barrel, we've got trouble here. When it goes to $50 or $60 a barrel, we have a catastrophe."

On May 20, Nauman Barakat, senior vice president at Refco Energy Markets in New York, predicted that the price of petroleum may reach $50 per barrel by September.

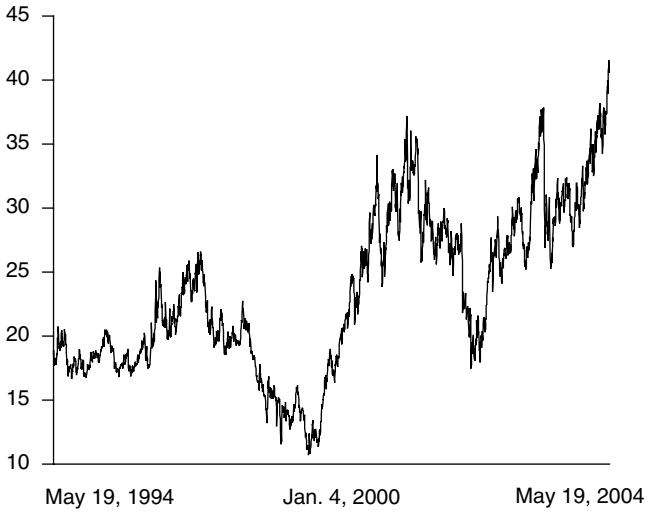
The U.S. economy's special vulnerability reflects several underlying factors. First, the price of oil is historically interlinked with the price of coal and natural gas: When the oil price rises, they rise in tandem. Second, the U.S. economy is possibly the most dependent upon fossil fuels of any industrial nation. When fossil fuel prices rise as a group, this triggers great instabilities in the fossil fuel-addicted economy. Third, the oil price increase feeds the hyperinflation which destabilizes the financial markets.

Moreover, the oil price increase is not occurring within a vacuum, but within a growing *systemic* financial breakdown, punctuated by rising interest rates. The increasing rates can pop the overly leveraged U.S. economic-financial system. The combination of the rising oil price with mounting interest rates will be lethal.

Price Gyrations

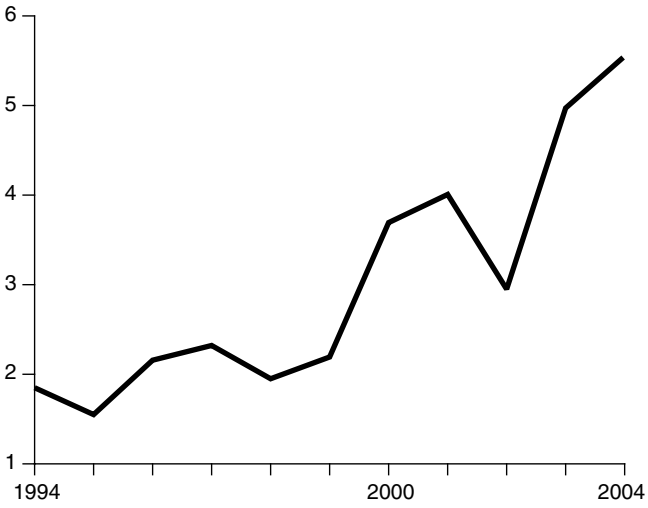
The governing reason for the oil price escalation is the eruption of a worldwide hyperinflation, defined by the phase change of LaRouche's "Triple Curve" collapse function, and resulting from Federal Reserve chairman Alan Greenspan and

FIGURE 1
Price of U.S. Light Crude Oil Futures Traded at the NYMEX
($ per Barrel)



Source: New York Mercantile Exchange.

FIGURE 2
Price of U.S. Natural Gas At the Wellhead
($ per 1,000 Cubic Feet)



Source: U.S. Department of Energy.

other central bankers' propping up the bankrupt financial system through money-printing. Within this context, other forces impelling the oil price rise include the effects of America's occupation of Iraq and Israel's genocide in Palestine, destabilizing the whole of oil-rich Southwest Asia; the crucial role of speculation; and America's decision to cut back oil refinery capacity during the past two decades.

Figure 1 shows the trajectory of the price of U.S. light crude oil futures traded on the New York Mercantile Exchange (NYMEX), which is a standard measure of the oil price. From Jan 2, 2002, the first day of trading of that year, the oil price moved upwards and downwards over 15 months, and then began a fairly steady upward climb starting the beginning of May 2003, to reach $41.70 on May 19 of this year, almost exactly double its January 2002 level. As emphasized above, the rise (or fall) in the price of petroleum, is invariably accompanied by the rise (or fall) in the price of natural gas and coal, perhaps with a time lag. There is no clear reason, but it would appear that this occurs in part because the leaders of the natural gas and coal industries take advantage of the higher oil price to tell other economic sectors, "you have to pay a price generally equivalent to that of oil, for our commodities." In addition, speculators pour money into the exchanges to manipulate upward the prices of natural gas and coal.

Figure 2 shows that the natural gas price trajectory is very close, in broad outline, to that of oil; it has increased by 118% since January 2002. While not shown, the trajectory of coal is similar. The price of Central Appalachian Coal Futures traded on the NYMEX, rose from about $29 per ton in January 2002, to $52 per ton in May 2004, an increase of 79%. Thus, since January 2002—and largely in the past 12 months—the prices of the principal fossil fuels have doubled.

The Fossil Fuel-Dependent Economy

Amplifying this crisis, the doubling of fossil fuel prices was inserted into an American economy trapped within a probable world's-worse dependency upon fossil fuels. The U.S. Department of Energy reports that in 2002, the United States economy consumed 97.6 quadrillion btus (quad btus) of basic "energy" stocks/supplies. Domestically-produced oil, coal, and natural gas are 55.8% of the total; imports of the same fossil fuels add 29.8% more. Combining the two in 2002, America consumed 83.5 quad btus of basic fossil fuels stocks. Therefore, a staggering 85.5% of America's energy supply comes from fossil fuels. A mere 8.4% of the total comes from nuclear power, and only 6.0% from "renewable resources," overwhelmingly hydro-electric power produced by dams.

How outmoded this is, can be seen in the fact that of the 17.7 quad btus of energy supplies consumed by America's manufacturing sector in 1998 (the latest for which information is available), only 5% derived from nuclear power and hydro-power. Some of the fossil fuels consumed in manufacturing were consumed as feed-stock—such as for petrochemicals, and plastics, fossil fuels' proper use—but a sig-

nificant amount were used as a power-source, a wasteful operation. This distortion also demands an overhaul of the transportation system. Instead of America being dependent on petroleum-powered cars and truck transport to move people and goods, were it to have a magnetically-levitated rail transport system, it could be powered by nuclear-generated electricity. America needs a crash program for nuclear energy.

The difficulties engendered when oil reaches the range of between $35 and $40 per barrel are clear:

- Airlines: The airline industry is highly indebted, and the aftermath of Sept. 11, 2001 left a legacy of reduced air travel. Now, each dollar increase in the price of crude oil cuts the airline industry's pre-tax profitability by $500 million per year, according to a report issued by Merrill Lynch. The industry is expected to lose $5 billion this year. The United and American Airlines surcharges on all flights are an inadequate stop-gap measure. United is already in bankruptcy; and U.S. Airways and Delta Airlines each announced in early May, that they too may have to file for Chapter 11 protection (for reasons not immediately tied to petroleum). Within this environment, the rising price of oil, passed on in the cost of jet fuel, could decimate America's entire air grid, a national security issue.
- Trucking: With diesel fuel prices averaging about $2.25 per gallon and no "market influence" to force shippers to pay higher rates, independent truckers, who own their own rigs, are finding it more and more difficult to make a living. On April 30, truck drivers, angry about the skyrocketing price of diesel fuel, parked their rigs on Route I-5 in California and disrupted freight movement from both Los Angeles and Oakland area ports. This type of action may become more common.
- Citizens: The average price of regular gasoline reached $2.02 per gallon on May 20; further, homes that are powered by oil and gas, face rising bills.
- Industry and business: Many companies are experiencing rising fuel bills. But fossil fuels are used as feed-stocks, and for example, since the beginning of the year, the price of naphtha, which is used in resins, has risen by 10-15%. The cost for the industries that make plastics, petrochemicals, synthetic rubber, etc., have risen, but a portion of this cost is passed on and must be absorbed by any company that uses plastic, petro-chemicals, etc. The cost of coking coal to make steel has risen, but with the general hyperinflation, so has the cost of iron ore and scrap steel for steel-making. The cost of wood is shooting up. The rising cost of fossil fuels, and other basic commodities, is eating away at company profits.

The current increase to a $40 per barrel oil price—and the attendant comparable increases in natural gas and coal prices—in such a dependent economy as America's, has created great strains. But were oil to rise to $50 per barrel, pulling up the other fuels, a large part of the U.S. economy would be functioning below breakeven.

The OPEC Myth

To obscure what is really going on, financial circles and their press have launched a widespread undertaking to blame the rising oil price on OPEC. It is necessary to take a moment to give an idea of what truly is going on. OPEC currently produces 23.5 million barrels per day (mbd) of crude. At the moment, OPEC members Algeria, Indonesia, Iran, Libya, Qatar, and Nigeria are producing at their capacity limit. Saudi Arabia has offered to increase capacity by another 1.5 mbd, which would take it close to its capacity. Total OPEC oil production would then reach 25 mbd. The world currently consumes about 82 mbd. OPEC would produce 30% of world consumption (and an approximately equal percentage of world production).

OPEC is not the problem. Its President Purnomo Yusgiantoro stated in early May, "The main problem with the recent high prices is closely linked to geopolitical uncertainties [Iraq], inadequate refining capacity in the United States to cope with rising demand, . . . and heavy speculation on oil by investment funds/speculators. All of these are factors about which OPEC has no control." The world's largest speculative oil markets are the International Petroleum Exchange (IPE), based in London, and the NYMEX, where 90% of oil trade transactions are speculative, carried out by some of the most powerful Anglo-American investment banks and metals houses.

The level of U.S. interest rates is moving up. Federal Reserve Board chairman Sir Alan Greenspan, and the rest of the members of the Federal Open Market Committee (FOMC), at their latest FOMC meeting in early May, held the Federal funds short-term inter-bank lending rate at 1%, a 45-year low. But even without explicit Fed action, interest rates have shot up: The 10-year U.S. Treasury bond yield has risen from 3.65% in mid-March, to 4.77% on May 20. Such Treasuries act as a benchmark for all long-term interest rates, and have forced upward the home mortgage interest rate. As a result, the Mortgage Bankers Association (MBA) reports that its index of loan applications—called the Market Composite Index—reached 654 for the week ending May 14, down 41.5% from the level of 1,117 for the week ending March 12. This index tracks applications for all types of loans, whether they be for new homes or for refinancing existing homes.

More specifically, the MBA's index for mortgage refinancings only reached 2,050 for the week ending May 14, down a whopping 58.9% from 4,984 for the week ending March 12. The fall of home loans and refinancings is setting the terms for popping the speculative U.S. housing bubble. Consumer spending tied to the housing bubble will take a big hit as well.

All of this is unfolding *before* Greenspan's expected raising of rates. Once rates are pushed up in an economy overhung with $36 trillion in debt of all types—and at minimum $70-80 trillion in notional amount of derivatives contracts outstanding—all hell will break loose.